THE PRICE OF PRIVATE OWNERSHIP

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ABOUT ten days ago the organization with which I am connected offered a million and a half of the ten year 6% bonds of a strong industrial corporation. In less than one hour the issue was absorbed and we had orders which we could not fill for another million. Last July a syndicate in which we joined offered an issue of ten year 6% obligations of one of the few railroad companies which has prospered during Federal control. After five months' effort the bonds are not yet entirely sold, while the price has fallen below that which the railroad company itself secured. On the first day of November an absolute first mortgage railroad bond, generally conceded to be perfectly good, matured and yet was not paid off in cash but was forcibly extended for three years because of the bankers' conviction that investors would not purchase at this time a refunding issue.

Is it not something of an anomaly that a 5% railroad stock, such as the New York Central, which has paid dividends for 50 years, should sell at a discount of 25 per cent. at the same time that an industrial stock like Baldwin Locomotive, receiving no dividends, sold at a premium of 50 per cent.; and when an 8% industrial, Underwood Typewriter, sells at 180, and a 7% rail, Great Northern, sells at 85?

From my knowledge of the bond market, I believe that owing to the present attitude of the investor, the successful flotation of new issues is impossible to all but a very limited number of railway companies. This preference on the part of investors for the securities of industries not subject to public regulation is one of the most pronounced characteristics of the market at the present time.

Opinions differ as to the causes of this discrimination. It has been alleged that the depreciation of railroad credit has been caused by statements made by railroad executives themselves and that the Interstate Commerce Commission has no responsibility therefor. To believe this is to confuse cause and effect. I do

not think railroad credit has been talked down any more than I believe we can talk it up now. A railroad company's performances outweigh a railway president's speeches when credit is in the balance. There is nothing artificial in the deterioration of railroad credit. It reflects the insufficiency of net revenues.

In the ten years ending in 1910 the carriers of the country earned an average of 5.25 per cent. on their investment. Only in the post-panic years 1904 and 1908 did the return sink below 5 per cent. With the exception of 1908, very little mileage was in the hands of receivers. The willingness of investors to purchase more than one and a half billion of new railroad stocks at par or higher is striking evidence of the public confidence then prevailing. With the adverse rate decision of 1910 confidence began to wane. In the next five years the return on railway investment averaged only 4½ per cent. and during 1914 and 1915 was very little better than 4 per cent. Few partnership risks were accepted by investors in this period and many thousand miles of road were operated by receivers. After 1915 came the rapid increase in traffic, making the results of 1916 and 1917 unusually good. But investors, realizing that those earnings were due to war conditions, properly enough, had little faith in their continuance. So while it is true that the rentals which the companies are guaranteed under Federal control are based on the highest average earnings ever received in any three-year period, railroad credit is not responsive; the distrust created by the low level of earnings in the pre-war years cannot be expunged by two years of good earnings since they resulted from an abnormal state of trade.

But 4½ per cent. represents affluence in comparison with the present earnings of the carriers. Were the Government to return the properties to their owners today without making provision for an extension of the Federal guarantees, or for an increase in rates, over 87,000 miles of railroad would presumably pass into the hands of receivers since these roads are not now earning their fixed charges. Nearly seven billions of capitalization would be involved in the crash. The dividend distribution on the stocks of other companies, aggregating one billion, one hundred million dollars, would forthwith be reduced or passed. Fortunately, Congress seems fully awake to this danger and is prepared to furnish a bridge, in the form of the extension of the Federal guarantees, until firmer ground is reached.

Another factor has aggravated the difficulties caused by low earning power. Money was much cheaper prior to 1910 than it has been since. The Pennsylvania Railroad Company, for example, borrowd $100,000,000 in 1915 at about 3½ per cent. In 1917 it paid 4⅝ per cent., and in 1918 approximately 5¼ per cent. Very few companies have borrowed long term funds since 1911 as cheaply as 4½ per cent., and yet, since the average productivity of the total railway investment was only about 4½ per cent. between 1911 and 1915, it follows that the owners of the properties were actually penalized for placing new facilities at the public service.

The railroad problem presents many sides, but underlying the whole difficulty is the question of credit. During the history of transportation there have been times when the relations between the railroads and the shipper and between the public and the roads have been none too cordial, but the identity of interests is today well understood. It must not be forgotten, however, that this identity of interests does not exist in the case of the investor. If he is not satisfied with the treatment he receives he will seek other fields. While he has already furnished the money for enormous additions and betterments to the railway plant we want him to supply a great deal more.

It is often said that the railroads need a billion dollars a year; the latest estimate, I observe, is two billions. We will keep our thinking straighter if we say that it is the public which needs these billions put into the railways. Failure to obtain new capital will react more disastrously on the public than it will on the carriers.

How can cordial relations be reëstablished between the railroads and the investor? The demand for new capital throughout the world is now, and will be for some years to come, in my judgment, in excess of the supply. Competition for it promises to be so keen that if we expect the railroads to secure their share we must be more than merely just; we must be generous in our treatment of them. This is the first and most important step in reëstablishing relations. I believe this can only be effected by assuring the roads net revenues of not less than 6 per cent. on their investment. While an average of 5¼ per cent., as I have already pointed out, met the situation a few years ago, it will not be liberal enough today when we take into consideration the present increased cost of capital, as well as the need of overcoming the hesitation or distrust of the investor. To give the carriers 6 per

cent. would mean the addition to net revenues of slightly more than $100,000,000 over the average of the test period. Twelve times this sum has been added to the pay of railway employees since the Government assumed control.

It is far easier to injure credit than to restore it, so we must not think that merely a friendly act of legislation is going to heal instantly the injuries that have accumulated in the past nine years. Indeed, some critics believe that credit is injured so mortally that only a government guarantee endorsed on securities will restore it to life. With this view I do not concur. I do not think the investor demands a guarantee but he will expect that those who determine how much his railroad shall receive for what it sells shall also accept responsibility for what it costs to produce it. There have been too many instances of running railroads with bondholders' or shareholders' money. The cost of railroad operation should be paid for by those who use railroad facilities, not by those who built them. If an arbitration results in an award of increased wages it ought to mean increased rates, not decreased dividends.

Senator Cummins fully appreciates that any remedial legislation must tender the investor reasonable security of principal and interest, and an important section of his bill addresses itself to that end. To accomplish this purpose, however, I think certain changes are essential. Its rule of rate making requires the Commission to adjust rates so that the carriers shall earn, as nearly as may be, 5½ per cent. on the aggregate value of their properties. It should be distinctly encouraging to the investor to have the Interstate Commerce Committee of the Senate agree that some increase in net earnings is not only warranted but necessary. It is my considered opinion, already expressed, that the return should be not less than 6 per cent. Furthermore, such return, until the physical valuations have been completed, ought to be measured, as it always has been, on the property investment accounts.

I am seriously disturbed by the proposal of compulsory consolidations. It will result in seven years of uncertainty, which means more costly and more difficult financing. It will deteriorate the credit of the strong roads and not help the credit of the weak. Inequality of earning power has dictated this proposal, since on a given rate structure one company may have a grossly excessive income while another may be bankrupt. But

the bill intends to correct this inequality by a division of excess earnings. Why then the necessity of compulsory consolidations? I personally cannot conceive of much durable satisfaction from the work of a few experts commissioned to redraw the railway map of the United States.

The next few years will be crucial to the railroads. Their credit needs every fortification. Senator Cummins' Bill requires each carrier to set aside one-half of its earnings between 6 per cent. and 7 per cent. for a reserve fund of its own, the balance reverting to a general contingent fund. I venture to suggest that in the interest of reëstablishing credit there should be no division of excess earnings until each carrier has built up its full individual reserve fund contemplated by the bill, that is, 5 per cent. on the value of its property.

The Esch Bill, as introduced, concerns itself chiefly with improvement in the machinery of regulation. Necessary as such improvements are they will never of themselves restore credit. In the form in which the bill passed, those few features in it that were calculated to encourage the investor have been carefully stricken out.

I wonder how many people realize that this problem of railroad credit is a public question of transcending importance. Failure to reëstablish credit at this juncture means government ownership. The price of private ownership is a fair return on the investment.

"No country," Mr. Acworth warns us, "has ever nationalized its railways as a result of deliberately weighing the respective advantages and disadvantages of public and private ownership." We have reached the parting of the ways. But whatever the decision, it is of far greater moment to the people of the United States than it is to those holding railroad securities.